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National City Bank

Monthly Letter on Economic Conditions Government Finance

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General Business Conditions

THE business situation during May has continued much the same as in March and April. For three months the inflationary forces have made no significant advance, and lately the markets for a number of basic commodities have been soft. Easiness in stock prices suggests uncertainty, at least with respect to corporate earnings. In some consumers' goods lines curtailment is in effect. On the whole, however, the country is intensely busy. Slackening in one place is offset elsewhere, retail sales are good if no longer phenomenal, and industrial operations in the aggregate continue at approximately the peak level reached in March. They are supported by a backlog of unfilled orders which for the manufacturing industries alone totalled $53.2 billion at the end of April, more than twice as great as the $21.8 billion held a year ago. In many areas labor is scarce. Unemployment is reported in some places, reflecting the shifts taking place in production, but in total it is below normal.

CONTENTS

In dollar terms the country has never had so large a product or enjoyed so large an income. While the dollar figures are inflated and include all that is going for defense as well as for civilian needs, it is probably also true that the physical quantity of goods available for every-day use, and therefore the real standard of living as a whole, has never been so high.

The check to the inflationary price rise, and the quieting of demand which is both a cause and a result, are due in substantial part to this immense production. Wants for specific consumers' goods with some exceptions are being well satisfied, in hard as well as soft lines. When the outlook for production of consumers' durables was appraised last fall, distributors felt that their problem would not be to sell but to get goods. But for the most part they find themselves with ample stocks on hand, output above expectations, and a good but not extraordinary demand for their merchandise.

It is clear that the twin fears of shortages and higher prices no longer have the compelling influence on buying sentiment that they had earlier; nor does evidence that production of durables will be reduced further seem to revive these fears. Announcement that the use of steel in automobiles in the third quarter will be cut to 65 per cent and in appliances to 70 per cent of the base period (generally the first half of 1950) has brought no clamor to buy. On the contrary, one automobile company has shut down temporarily because its production was outrunning sales, and used car prices have continued easy.

Influences on Demand

It is not always possible to say what governs market sentiment, but one inference is that more people believe the uprush was overdone and the interference of defense work with civilian supplies overestimated, at least as to timing. The feeling seems to be that "wolf" has been

cried, but the wolf has not yet appeared. People now ask whether demand can continuously absorb the present volume of production, during the period that must still elapse before the arms factories are in full swing. The rise in inventories, business and personal, together with the extent to which future needs have been anticipated, inspires caution.

Moreover, there is a general reservation, present in many minds, as to what will happen if a cease-fire should be negotiated in Korea and international tensions elsewhere should ease. To this the answer in Washington would be that even with the most favorable developments that could be hoped for the country would still be in peril, and that the armament program cannot be relaxed in the slightest. Most people accept this as correct. Nevertheless there are degrees of urgency.

At the same time, the measures taken to restrict demand are showing considerable effectiveness. People are paying higher taxes and facing still higher ones. Restrictions on consumer and mortgage credit, in conjunction with the change in money policy, the voluntary credit restraint program and a tighter money position all around, are bearing fruit. The stockpiling policy, which has had so much to do with scarcities of strategic materials both here and abroad, is more moderate. The number of housing starts has dropped to a level which makes it appear that the objective of holding them down to around 850,000 this year will be achieved. The total of instalment credit outstanding is diminishing, which means that some current income is being applied to extinguishment of debt instead of purchase of goods.

When these developments are coupled with the tremendous outpouring of goods, it is understandable that the inflationary psychology has weakened in the way the markets now show.

Inflation Still the Danger

In the circumstances some think it is a mistake to maintain regulations designed to restrict demand, and that the result will be unnecessary unemployment and business loss. This view, however, underrates the strength of the factors sustaining business now, and also gives insufficient weight to future dangers. The current easing should be considered beneficial and gratifying, rather than a threat to activity and employment, and we believe most people so consider it. The inflation already has been costly. It would have been worse if anti-inflationary measures had not been taken. Inventories would have been larger, debts greater, price distortions and inequities more extreme, and the business situation more vulnerable.

The weight of economic opinion is that inflationary forces are still dangerous, and that it would be foolhardy to take the risk that they may get out of hand again. Even in April, a relatively quiet month, new orders received by the manufacturing industries exceeded shipments. Defense orders are being placed at the rate of a billion dollars a week, and Mr. Wilson says defense expenditures will reach that figure by the end of the year. The immense industrial activity that is in sight will be pouring out purchasing power, but not all the goods produced will be available for those who get the purchasing power.

The attention given to accumulated retail inventories, and to the weakening of the markets for soft goods, may be exaggerated. For three months department stores have been buying less than they have sold, according to Federal Reserve Board statistics. Considering the typically short cycles of soft goods fluctuations — especially in a time when overall production and employment are sustained by the heavy expenditures on defense and business plant and equipment — this is getting the correction well under way. Competent judges consider the outlook for fall apparel business good.

Moreover, stores have accumulated durable goods more than soft goods, according to the inventory analyses which the Reserve Board publishes. As respects the supply of metals for consumers' durables, the wolf is now appearing, after the earlier false alarms. The essential fact is that the supply of materials, and probably of manpower also, will not permit continuing the output of consumers' durables at recent rates. It is fortunate that demand is subsiding naturally, due to temporary market saturation. Otherwise the inflationary problem would be, to that extent, less manageable.

The Longer Outlook

The end of June will complete the first year since the beginning of the Korean war and the enlargement of the defense program. For the next twelve months, running through June 1952, a few assumptions may be confidently made. One is that defense expenditures will rise again by as great an amount as they have increased during the past twelve months, and probably more. During the past year the increase in defense spending, from an annual rate of about $12 billion to a current rate of nearly $30 billion, has been supplied out of an equivalent increase in overall production. The gen-

eral standard of living has not been reduced; as stated at the beginning of this Letter, it probably has never been so high.

It is hardly to be expected that a still greater increase in defense expenditures during the next twelve months can also be met entirely through expansion of physical output. The planning of Mr. Wilson and his aides does not rest on such an expectation. On the contrary, Mr. Wilson asks everyone to accept some reduction in consumption in order to make materials and manpower available for defense preparations, for actual armament output, and for necessary expansion in business plant and equipment so that total output can be increased. This is the "hump" theory. If it works as intended the result will be that when enough new plants are brought in and materials provided progress in raising livings standards can again be resumed, and defense needs likewise supplied, out of the increased output. Mr. Wilson has said during the past month that expansion of steel, aluminum and synthetic rubber output should catch up with requirements by June, 1952.

Since this policy requires the application of a greater proportion of the country's manpower and materials to armament and capital goods than in the past year, it also presents an inflationary danger, unless there is a corresponding diversion of purchasing power from consumers' goods to armaments, primarily through taxation, and to capital goods, primarily through saving and investment. The danger is simply that the diversion of purchasing power will fall short, and that the total of government and capital goods expenditure will exceed the total of taxes and savings. In that case the deficit will have to be financed by expansion of credit, and there will be an addition to money purchasing power without an equivalent increase in the supply of goods for the consumer.

To Balance Investment and Saving

To keep the situation in balance the problem should be attacked from all sides. First, non-defense expenditures should be reduced, not only by rigid economy but by elimination or deferment of public works and private capital projects that are not essential for direct defense or to support the defense program. To accomplish this the Government has powers over the allocation of materials which, if used rigorously, can effectively screen and limit the amount of work which local governments and private builders can undertake.

Second, Congress should levy taxes not only for the purpose of balancing federal receipts and expenditures, but for the purpose of repressing private spending. This implies emphasis on taxation of personal incomes in the brackets where the bulk of the increased spending power now exists; or alternatively, taxation of spending directly, by the imposition of sales levies.

Third, access to credit, whether government or private, should be difficult rather than easy, in order to avert a wholesale substitution of credit expansion for saving and to limit the use of credit to productive and non-inflationary purposes.

Fourth, savings should be encouraged and induced in all possible ways — by fixing attractive rates on savings instruments, by appropriate publicity and sales campaigns, and finally by adherence to policies which will maintain confidence in the future purchasing power of the money saved.

Along these lines much is being done. Progress is being made in restraint of credit, both directly and through general monetary policy. Government expenditures in the first year after Korea have been more than covered by receipts; with new tax increases in the making the cash deficit in the forthcoming fiscal year can be held to relatively small proportions if not completely avoided. Limitations on non-essential projects are operating with the voluntary credit restraint program to keep expenditures in the capital goods field within what can be supplied.

On the other hand, the reluctance of Congress to concentrate new taxation in the income brackets where the bulk of the spendable income now lies is an obstacle to effective inflation control. The effect of even excise taxation, which is particularly desirable now because it falls on spending directly, is weakened because the taxes are included in the price quotations from which the cost of living index is compiled. Where escalator contracts are in effect, wages rise with the cost of living. Hence the taxes may be escaped by becoming indirectly the basis for higher wages. To that extent they actually have an inflationary effect.

Wages and Incomes

Another assumption applying to the next twelve months which may be confidently made is that average wage rates, industrial costs and wage incomes will rise, contributing to the inflationary forces. Wage increases granted since Korea are still spreading, and negotiations for further advances are beginning in important

industries. The Wage Stabilization Board is now dealing with some 3,000 applications (at last report) for increases which would exceed the 10 per cent rise (over January 1950) allowable under the formula adopted last February. The Board's decisions have breached that formula — if strictly interpreted — in the meat-packing employes' case and in other instances. It seems apparent that a new formula will be evolved under which further widespread advances can occur, and that gradually wage rates in general will adjust to a higher level. In short, wage stabilization is loose, not tight.

A continuation of this drift will not only raise costs and force price increases, but will raise wage disbursements and money incomes. Taking account not only of rates but also of greater employment and some extension in the average work week, Professor Slichter of Harvard estimates the increase in payrolls a year hence, as compared with the present, at $21 billion annual rate. The Congressional Joint Committee on the Economic Report places it even higher, at $23.5 billion. There is no prospect that such increases will be either absorbed by taxes or offset by equivalent increases in output of consumer goods, and it would be expecting a good deal to think that there will be a commensurate increase in savings. The conclusion is that much of the increase in wage payments will come into the markets as demand for consumer goods, with inflationary effects because it operates against a relatively fixed supply.

The Problem Is Manageable

The foregoing analysis supplies arguments against complacence that may arise out of the present relative ease in the markets. It emphasizes the need of resolution in facing the inflationary dangers and carrying out appropriate policies to deal with them.

But it should be said also that the quieting of the inflationary forces in the past three months is a heartening and reassuring development, which should help the country and the government to appreciate that the inflationary pressures do not grow constantly and irresistibly. They subside as well as expand, due to the ebb and flow of natural influences as well as to repressive policies.

One lesson of the present situation is that the further pressures to come have been anticipated and discounted to an important degree. It is not to be expected that inventory accumulation during the next twelve months will be anything like that of the last twelve, for distributors will not pile more on top of what they have, and tightness in raw materials supplies will prevent manufacturers in general from adding more than they can use. The change in consumers' buying psychology — which, to be sure, can change again — is evident. In some basic commodities the price rise was clearly overdone, chiefly through public and private stockpiling, and market positions are now less tight. This is true particularly of rubber, tin, and some of the foodstuffs; and even the wool price has reacted because it had reached a level which threatened to drive consumers out of the market. While there is no general limit to demand, markets for specific goods become saturated. This has lately seemed to be happening in a good number of lines.

In mathematical terms defense expenditures are expected to rise to something over 15 per cent of the total output of the country. Total output, however, will be the greatest ever known. Nearly 85 per cent for civilian needs will leave those needs very well supplied. This is not the World War II situation, or anything approaching it.

Taking into consideration the outpouring of goods to be expected, the extent to which the pressures to come have been foreseen and discounted, and finally the restrictive measures already in operation, it need not be assumed that inflationary developments must inevitably and necessarily go much further. The outcome is in the hands of governments and people. If federal and local government expenditures are restrained and budgets kept balanced, if money policy follows firmly the present objective of making it difficult for people to go into debt except for clearly productive purposes, it may be found that a good deal of the inflation to be expected from the defense program is already behind us. To be sure, people have it in their power to produce a runaway by cashing in savings and fleeing into goods. But they have it equally in their power to keep the situation in hand, not only by working and saving themselves but by supporting firm fiscal and monetary policies which tend to maintain confidence in money as against goods.

Treasury Financing Plans

After an interval of five months since the refunding of $8 billion in bonds and certificates of indebtedness December 15 and January 1, the Secretary of the Treasury announced on May 29 his plans for handling the next block of debt maturities, aggregating $10 billion June 15 and July 1. This is a big slice of the Treasury's 1951 maturities, the successful refunding of which, it

has been feared, might require large-scale Federal Reserve support and a relaxation of the pressure the authorities have built up in the money market as a discouragement to further credit expansion. These June-July maturities are the first ones to come up (except for the weekly Treasury bills) since the abandonment of fixed price supports in the government securities market under the Treasury-Federal Reserve "Accord" of March 3. In the meantime, March 26 to April 6, the Treasury has carried out a conversion of $13½ billion 2½ per cent marketable bonds into 2¾ per cent non-marketables. This was a special operation, designed to take pressure off the market, and did not involve any maturing securities.

The issues coming due now are $1,627 million of partially tax-exempt 2¾ per cent bonds previously called for payment on June 15 and three issues totalling $8,445 million of 1¼ per cent notes due on July 1. Holders of these are being offered in exchange nine and a half months certificates of indebtedness dated June 15, carrying an interest rate of 1⅞ per cent and maturing April 1, 1952. The issue is well designed from the standpoint of current market conditions and will fall due at a time when the March, 1952, tax revenues will have placed the Treasury in good cash position.

Of the $10 billion of maturing securities, $1.8 billion are held by the Federal Reserve Banks and doubtless will go in for exchange. The balance of $8.2 billion is spread out among thousands of holders, with the largest amounts held by banks, corporations, and foreign governments. The Treasury can count on considerable exchanges by present holders who do not need their money now but may see a need for it next year. Others, who do not hold the maturing securities, will want to buy the new certificates. While there is outstanding no less than $26 billion marketable government securities that the Treasury may at its option call for payment in 1952, there are none outstanding which give the investor the assurance of cash redemption on a specific date in that year.

The rate on the new certificates is the best the Treasury has put on such securities since 1933, and a full 1 per cent above the ⅞ per cent rate on one-year certificates artificially maintained by the Federal Reserve Banks in World War II financing. In the current market, with 91-day Treasury bills selling to yield 1.6 per cent, and four-year notes near 2 per cent, the new certificates should command a premium adequate to produce a successful exchange without substantial Federal Reserve intervention. Thus it looks as though the financing would not interfere with the Federal Reserve's anti-inflation policy.

Obtaining the exchange of maturing securities held by people who want cash at maturity is the most tricky part of any large exchange operation. This requires that exchange must be made so attractive that any holders not wishing to convert will sell the rights. The familiar, easy and inflationary way to accomplish this is to have the Federal Reserve Banks offer premiums for the securities, make the exchange, and put the new obligations into their portfolio. The sounder way is to design securities that will be in sufficient demand to make the exchange rights valuable in a free market.

Action on Callable Bonds

Besides setting its exchange terms for the June-July maturities, the Treasury took other noteworthy steps during May to deal with its financing problems. On May 15 the regular four months' notice was given that the partially tax-exempt 3 per cent bonds of 1951-53, first callable for payment on September 15, will be due and payable at that time. These bonds, outstanding in the amount of $755 million, have a remarkable history behind them. They were sold as 20-24-year bonds in September 1931 just as the British pound was breaking under the stress of international financial strains, traded as low as 82⅛ four months after issuance (yielding 4¼ per cent) and ten years later went as high as 113 (yielding less than 1¾ per cent).

While calling these 3s, which will be refinanced with fully taxable obligations, the Treasury passed up its option to call for payment September 15 the much larger $8 billion issue of 2 per cent bonds of 1951-53, leaving these to be refunded in March or September of 1952 or 1953 as the Secretary may elect. This cut $8 billion from the potential refunding program for the balance of 1951. The marketable obligations due or first callable from August 1 through December 15, which remain to be dealt with, run to $20 billion but nearly half of these are held by the Federal Reserve Banks.

New Savings Note Issue

The Treasury took another step during May to strengthen its cash position in the offer of a new issue of Savings notes, denominated "Series A", in place of the Series D Savings notes the rate of interest on which was out of line with the market. These securities are designed to

attract tax reserve funds and may be tendered in satisfaction of income, estate, or gift taxes.

The new Series A Savings notes, like their predecessor issues, and also like Savings bonds, are not traded in the open market but have a fixed scale of redemption values depending upon the length of time they are held. The return offered on the new "A" series ranges from 1.44 per cent for six months' holding up to 1.88 per cent for holding the full term of three years. The yields on the former Series C Savings notes ranged from 0.96 per cent for six months' holding up to 1.40 per cent for three years. This improvement in rate of return reflects the higher money rates. The new issue should lead to an increase in the $8.1 billion total of Savings notes outstanding at the close of April.

These moves in public debt management implement the Treasury-Federal Reserve "Accord" of March 3, avoiding unnecessary dispersal of Treasury or Federal Reserve cash into the money stream and giving tangible incentives to the investment of idle funds in government securities. To people who have been concerned by the erosion in the buying power of the dollar, there is in the new course of monetary and credit policy a source of justifiable reassurance.

Taxation for the Overprivileged

According to newspaper dispatches from Washington, the Ways and Means Committee, framing a new $7 billion revenue bill for House action this month, reached agreement May 9 on a 3 point increase in the schedule of personal income tax rates. The administration had asked for 4 points. The tax scale, now graduated from 20 per cent up to 91 per cent, would be made to run from 23 per cent up to 94 per cent, exactly where it stood during the closing years of World War II.

On May 23 the Committee reconsidered this action on the ground that it would be too hard on the little fellow and too easy on the rich, and decided that it would be more fair and proper to tack 12½ per cent onto the present tax and to call the increase a "defense tax." Either plan, it was estimated, would add nearly $3 billion to the revenues.

The Committee's reasoning was simple. A raise from 20 to 23 cents on the first dollar of taxable income is a 15 per cent increase in tax; a raise from 91 to 94 cents on the last dollar of a taxable income of $200,001 is a piddling increase of 3.3 per cent. Ergo, crowning injustice is done.

Perhaps none of the lawmakers is among those privileged, under present law, to keep as little as 9 cents out of a dollar of income. In any event, no one seems to have noticed that the harmless sounding 3 point tax rate increase is three cents out of nine cents the taxpayer now has left out of a dollar's income in the topmost bracket. The important thing is not the percentage increase in tax rate but the percentage effect on take-home pay. On this test, the increase from 20 to 23 cents on the first dollar of taxable income would reduce the take-home pay from this dollar of income from 80 to 77 cents, a 3¾ per cent cut. The 3 point method "favors" the rich by clipping take-home in the top bracket 33 1/3 per cent. This is on top of the Revenue Act of 1950 which had appropriated half of the take-home in this bracket.

Without taking time to ponder such considerations, the Committee adopted the alternative of the "defense tax" computed at 12½ per cent of the present tax. The drastic results of this scheme are seen in the table below:

Take-Home Pay Per Dollar of Taxable Income

	Taxable Income Bracket			
	0—$2,000	$16,000—18,000	$80,000—90,000	$200,000—Over
Revenue Act of 1948	83.4c	56c	26.1c	17.9c
Revenue Act of 1950	80c	50c	16c	9c
Rates raised 3 pts.	77c	47c	13c	6c
Tax incr'd 12½%	77.5c	43.8c	5.5c	— 2.4c
Loss in take-home pay in comparison with present law:				
From three point rate raise	— 3.8%	— 6.0%	—18.8%	— 33.3%
From 12½% tax increase	— 3.1%	—12.5%	—65.6%	—126.4%

It is instructive to see what justification there was for labelling the 3 point rate raise a "soak-the-poor" measure. It does not affect a family of four with an income of $50 a week or less since pay is fully covered by exemptions and deductions. The difference between the two methods to the person who just makes the first tax bracket is a fraction of one per cent, or something less than "peanuts" by the standards of wage negotiators. The most help the 12½ per cent scheme has to offer is to a family with a total income of $10,000 to $15,000 a year—three or four times the national average—and here the advantage at most amounts to $30 a year or 58 cents a week.

Point of No Return

These savings, insignificant as they are in percentage terms, but spread among tens of millions of individuals and families, would demand taxation even more confiscatory than we now have on the person fortunate or unfortunate enough to attain the pinnacles of success. The

12½ per cent tax-on-tax adopted May 23, would put the maximum tax rate at 102.4 per cent.

It does not seem reasonable to suppose that people would put much heart into working to build and protect income only to have it completely confiscated by the Government. There is not that much joy in paying taxes. Hence the 12½ per cent clearly jeopardized the revenues, and the Committee subsequently amended its scheme to establish 94½ per cent as the maximum rate of tax, applicable to taxable income in excess of $80,000. Earlier in May the maximum the tax can run was set at 90 per cent of total taxable income, and the taxpayer is thus assured at least a minor commission for earning and honestly reporting his taxes.

Either the 3 point rate raise or the 12½ per cent tax increase would go beyond the taxation on creative talent put in force during the 1930's in efforts, never successful, to balance the budget. Even the 10 per cent defense tax enacted in 1940 contained a relief valve that limited the loss of take-home pay to 10 per cent. The maximum effective tax rate then became 81.1 per cent, applying to taxable income above $5,000,000. The wartime Revenue Act of 1944 put the top rate up to 94 per cent and applied it to taxable income above $200,000. Now the plan is to have a rate of 94½ per cent apply to taxable income above $80,000. Such a rate, it is pertinent to observe, makes a dollar of illicit, unreported income worth eighteen times as much as the dollar honestly earned and reported.

The record on this kind of taxation is that it produces, not additional revenues, but forced liquidation of income-producing properties, suffocation of opportunity, tax avoidance, and, in the end, the destruction of revenue sources. In the crisis we face we need the fruitful energies of every citizen, not least of all the law-abiding citizen who works for advancement and shoulders bigger responsibilities. No egalitarian society has ever won a war.

One main lesson out of this experience is how little there is left to tax in the upper income scales. If substantial additional revenues are needed new levies will have to be placed on the average man of average income and wealth. It can be accomplished in varied ways, but that is where the bulk of the national income is earned. As the President's Council of Economic Advisers pointed out earlier this year:

> by far the largest part of the additional revenue must come from the middle and low tax brackets. These are the brackets in which the great bulk of the income is located. Of the net income on all taxable returns, 86 per cent of the amount remaining after federal income taxes is estimated to be received by taxpayer with net incomes of less than $10,000. To hold down consumption, which is vital to the control of inflation, the bulk of consumers must be affected directly by tax increases.

Voluntary Credit Restraint Program

The April issue of this Letter referred to the inauguration of the "Program for Voluntary Credit Restraint", which established the framework for voluntary cooperation by lending institutions in restraining credit expansion and limiting the inflationary impact of the defense expenditures.

In the situation created by the rapidly expanding defense activities it was recognized that credit controls of some kinds would be essential. These controls could be of two broad types.

First, there are the controls imposed upon lenders by action of the monetary authorities. These, in turn, can be broken down into (a) the traditional method of central bank action in influencing the volume and cost of credit through use of the discount rate and of the so-called "open market operations" in the purchase and sale of government securities; (b) selective controls exercised through regulation of particular kinds of lending; and (c) general controls such as imposing higher bank reserve requirements in one form or another, or putting arbitrary ceilings on bank credit.

The trouble, however, with these types of controls is that any effort to apply them vigorously runs into complications. With the huge size of the national debt and its management problem, the central bank no longer has the same degree of freedom of action it used to have in exercising the traditional instruments of credit control. Moreover, any drastic tightening of money generally would hit essential as well as non-essential lending. This is all the more true of measures that would place arbitrary limits on bank credit.

As regards selective controls, the fact is that the general run of bank loans does not readily subject itself to rules. Outside of mortgages, security loans, and consumer credit, loans do not run to pattern. Any attempt to put them in too many separate pigeonholes would cause hopeless confusion and many inequities. For this reason borrowers as well as lenders have a vital interest in avoiding further moves in this direction.

We come, then, to the second broad type of control — that which lenders can exercise upon themselves. This has the enormous advantage of operating flexibly, with opportunity for the play of individual judgment in each particular case. Such control, if effective, can be a power-

ful supplement to other methods of credit restraint and help to stave off more drastic types of control.

Organization of the Program

It was with these considerations in mind that the Voluntary Credit Restraint Program was set up under the provisions of Section 708 of the Defense Production Act of 1950. Authority to establish the program was delegated to the Federal Reserve Board, which body consulted with the Federal Trade Commission and obtained the approval of the Attorney General for the program on March 9, 1951.

The plan operates through a "Voluntary Credit Restraint Committee" appointed by the Federal Reserve Board and composed initially of representatives of three major types of lending institutions — commercial banks, investment bankers, and life insurance companies — together with Governor Oliver S. Powell of the Reserve Board as chairman. More recently representatives of the mutual savings banks and of the savings and loan associations have been added.

The national committee has in turn set up regional committees, available for consultation by institutions participating in the program, such consultation taking the form of discussion of the type of loan involved rather than by the name of the prospective borrower. To start with, the commercial banks had one regional committee for each Federal Reserve district, but already the number is being expanded as interest in the program has grown and various smaller regions have expressed a desire to have their own committees. The investment bankers and the insurance companies each have four regional committees, while the mutual savings banks and the savings and loan associations are in process of setting up their committees.

Statement of Principles

The Federal Reserve Board, in its letter of March 9 to all lending institutions calling for their support in setting up the program, had expressed its approval of a "Statement of Principles" drafted by representatives of the lending institutions and approved by the Attorney General. The test for desirable lending under today's conditions was stated to be whether the loan would commensurately increase or maintain production, processing, and distribution of essential goods and services. The statement listed as "proper" the following types:

1. Loans for defense production, direct or indirect, including fuel, power and transportation.
2. Loans for production, processing and orderly distribution of agricultural and other staple products, including export and import as well as domestic, and of goods and services supplying the essential day-to-day needs of the country.
3. Loans to augment working capital where higher wages and prices of materials make such loans necessary to sustain essential production, processing or distribution services.
4. Loans to securities dealers in the normal conduct of their business or to them or others incidental to the flotation and distribution of securities where the money is being raised for any of the foregoing purposes.

The Statement listed the following types that should not be made under present conditions, "unless modified by the circumstances of the particular loan so as not to be inconsistent with the principles of this program":

1. Loans to retire or acquire corporate equities in the hands of the public, including loans for the acquisition of existing companies or plants where no over-all increase of production would result.
2. Loans for speculative investments or purchases. The first test of speculation is whether the purchase is for any purpose other than use or distribution in the normal course of the borrower's business. The second test is whether the amounts involved are disproportionate to the borrower's normal business operations. This would include speculative expansion of real estate holdings or plant facilities as well as speculative accumulation of inventories in expectation of resale instead of use.

Subsequent Committee Bulletins

Subsequent to this "Statement of Principles," the national committee has issued three major policy bulletins for the further guidance of regional committees, lending institutions, and borrowers.

The first bulletin, issued March 20, dealt with inventories, then considered the matter of most immediate concern. Calling attention to the rapid rise in inventories, particularly at wholesale and retail, and its effect in contributing to the rise of prices, the committee noted that "an important part of this abnormal increase in inventories has been financed by borrowed money." The committee urged lenders to —

1. Refrain from financing inventory increases above normal levels relative to sales, or reasonable requirements by other conservative yardsticks.
2. Encourage borrowers who already have excess inventories to bring these commitments and inventory positions in line as promptly as is reasonably practical, thereby reducing the amount of credit being used in this manner.

Bulletin No. 2 dealt with credit for plant expansion. The committee cited government surveys indicating that business concerns are planning to spend the record sum of $24 billion on plant enlargement and modernization this year. Only about half the proposed expenditures, it was said, can be classed as defense or defense supporting, the balance being borderline cases

or clearly non-essential and deferable. Pointing out that some of these expenditures would be stopped by limitations and allocations of materials, the committee proposed that, for projects other than those whose essentiality has been predetermined by government agencies, certain tests be applied by lenders in making financing decisions. Loans, it was suggested, might well be postponed if for such purposes as:

1. Construction of facilities to improve the competitive position of an individual producer of non-essential goods.

2. Expansion and modernization expenditures of concerns in distribution or service lines where the distribution or service is not defense supporting.

3. Expansion and modernization programs for the manufacture of consumer goods not related to the defense effort.

Bulletin No. 3, circulated by the committee on May 7, took up the question of state and local government financing. Issued in conjunction with the letter of the same date from Defense Mobilization Director Charles E. Wilson to governors of all states, mayors of major cities and financial officers of principal counties and political subdivisions, this bulletin stressed the inflationary dangers and urged the postponement of borrowing if the project is postponable. Both the credit committee bulletin and the Wilson letter singled out soldiers' bonus payments, war memorials and municipal recreational projects as examples of projects that should be postponed. The credit committee enumerated a somewhat expanded list as follows:

1. Replacement of any existing facilities that can continue to perform their function during the emergency period.

2. Construction of facilities of the types not recommended by the Defense Production Administration — such as recreation facilities and war memorials.

3. Acquisition of sites and right-of-way not immediately needed.

4. Purchase of privately-owned utilities by municipalities, which involves borrowing to replace equity capital.

The Wilson letter took the important step of requesting that during the defense emergency every state and municipal borrowing of $1 million or over be cleared in advance by one of the Voluntary Credit Restraint Committees. This action, which was paralleled by a request from the central Voluntary Credit Restraint Committee to all financing institutions not to participate in the purchase or sale of such issues until they had been cleared in accordance with the principles of the credit restraint program, puts these committees, insofar as state and municipal issues are concerned, in the same position as the Capital Issues Committee which functioned effectively in World War I.

Compliance Voluntary

In all the talk about setting up committees and making rulings, it should be emphasized that compliance generally is on a wholly voluntary basis. Except in the case of state and local government financing of more than $1 million, no financing institution is requested to consult with any committee unless it feels in doubt as to whether the financing is consistent with the purposes of the program. The option to consult or not to consult is with the lender.

The distinction with respect to state and local government financing is in the request by both Mr. Wilson to prospective borrowing communities and by the national credit committee to the financing institutions that all issues of more than $1 million, regardless of purpose, be cleared in advance by a Voluntary Credit Restraint Committee. This is in recognition of the fact that the established procedure for originating and bidding on public issues does not afford the same opportunities for preliminary negotiation and discussion between lender and borrower that is true for other types of financing. While in the case of public financing of less than $1 million borrowers and lenders are not requested to clear all issues in advance, they are asked to do so, as in case of other types of financing, when in doubt as to whether the purposes are in accord with the spirit of the program.

Whether the financing be for a public body or for private industry, the final decision with respect to making or refusing to make any particular loan or bid on any particular issue of securities likewise remains wholly within the individual and independent discretion of each financing institution, whether or not it has consulted with any of the committees. The committee does not even go so far as to declare whether the loan should or should not be made. It merely states whether in its opinion the proposed financing is in accord with the purposes of the program. It is then up to the financing institution to decide whether it will be guided by the judgment of the committee. As indicated previously, in consulting with a committee financing institutions are not required to disclose the identity of the applicant for any loan.

Will the Program Work?

The question of course that everyone is asking is, will the program work? Will lenders really discourage loans to good customers which meet all the usual credit tests and which can only be objected to on grounds that they fail

to conform to the principles of the program? In short, has the program enough "teeth"?

The answer to these questions is that the program *is* working, though it takes time for a thing like this to develop. The plan was only launched in March and there has been a great deal of organizational and educational work to do. The success of any effort of this kind depends upon spreading the gospel so that people — lenders and borrowers alike — understand what is being attempted and give it their wholehearted support. This is not done in a day.

During the past three months the voluntary credit control program was reinforced by two other developments. The general softening in the demand for consumer goods and the realization that excessive inventories had accumulated in many lines exerted a dampening effect on further borrowing to carry inventory. At the same time, the action of the Federal Reserve Open Market Committee in unpegging the government bond market, and allowing substantial declines in market quotations, has been more effective than most people realize in discouraging loan expansion based on the sale of government securities. Though the rise in commercial, industrial, and agricultural loans of banks has tapered off in the past month, it is not clear to what extent this has been due to the voluntary credit restraint program and how much to these other factors. It is true also that defense borrowing has been increasing and has tended to obscure the trend in non-defense loans.

In recognition of the need for more precise knowledge of the trend of bank credit, the national committee has asked the Federal Reserve Board to obtain detailed weekly reports from the larger banks. Reports from some 200 of the leading banks, representing about 65 per cent of the total bank loans of the country, are now being received and tabulated at the various Federal Reserve Banks and are being used by the voluntary credit restraint committees. The figures show by major business classifications defense and defense-supporting loans broken down as between those for plant and equipment and those for other purposes; and the same in greater detail for non-defense loans.

Lenders Taking Hold

While proof of accomplishment is not yet measurable in exact figures, people connected with the program are impressed by the widespread response it is generating among lending institutions of all kinds. This is evidenced by the discussions at meetings of state and local bankers' associations throughout the country, in the requests for more regional committees, and in the literature being distributed by banks to inform the business public. Similar interest is being displayed by other lending institutions.

Particularly gratifying are the increasing reports that lending institutions are really applying the principles of the program as they come to understand them better. While criticism has been made that the statement of principles is "too general" and "wide open as a barn door," the fact is the committees are finding that when they get down to individual cases it is perfectly possible to make rulings. With knowledge of the individual circumstances and an understanding of the philosophy, both the committees and the financing institutions themselves are experiencing less and less difficulty in screening out financing that does not conform to the purposes of the program.

The failure of the State of West Virginia last month to get any bids from investment banking syndicates on the state's $67,500,000 soldiers' bonus bonds has been the outstanding example. Syndicates which had been formed months ago to bid for the bonds declined to go ahead following an opinion by a credit restraint committee that the proposed financing was not in harmony with the objectives of the voluntary credit restraint effort. And, as was stated in the financial columns of the New York Times of May 25, "unpublicized decisions to the same effect are being made daily by bankers all over the country, despite the charge, born of easy cynicism, that the financial community is only and forever interested in 'business as usual'."

What of the Borrowers?

But what about borrowers; how are they going to feel about this plan for restricting credit to which many may believe they are justly entitled?

The answer here is that developing an understanding attitude among borrowers is also an essential part of the program. The compelling fact that all must recognize is that the country is trying to do too much — there simply aren't the manpower and materials to carry through the defense job and still leave room for everybody to do everything they want to do at the same time. Some things have got to wait.

Thus the real choice that borrowers as well as lenders face is whether they want mandatory controls imposed from above or whether they want to work things out together in a flexible, democratic manner. The Voluntary Credit Restraint Program is an effort to do it the latter

way. It doesn't mean that there shouldn't be bank loans, that there shouldn't be inventories, that business — even non-defense — should be under absolute prohibition to undertake expansion. We are not, after all, in an all-out war. If the economy of the country is to remain healthy much of the normal business must go on.

What it does mean is applying the rule of reason instead of the meat-axe approach. How do the purposes for which credit is sought compare with the borrower's normal requirements? What degree of essentiality from the standpoint of the defense program is involved? What special circumstances call for consideration? Can the project, if not deferable, be trimmed down? These are all common sense tests that borrowers, as well as lenders and credit committees, can apply. To a large extent they represent merely the kind of scrutiny that good banking and good business judgment would call for even if there were no credit restraint program.

Government Agencies Must "Play Ball"

Finally, the success of the program will depend not only upon the attitude of borrowers and private lending institutions, but also upon the extent to which government agencies "play ball".

First, there will be need for close coordination between Mr. Wilson's office in the allocation of materials and the voluntary credit control committees. For it is in the markets for materials that the inflationary pressures are expressed. To the extent that we can lessen the scramble for materials by cutting down their use for non-essential purposes the credit problem is relieved. However, determining essentiality is primarily a government function, not one in which private citizens can be expected to take the leading part. Where loan applications for projects that Washington has cleared as to materials come before the regional credit committees, the latter will be under considerable pressure to accept their essentiality as having been already established. Hence the need for careful screening by Washington in the first place.

Second, government lending agencies also must attune their policies to this program. If prospective borrowers turned down in consequence of opinions by the regional credit control committees can run to Washington and get the money from government lending agencies, the whole program will be hard hit.

President Truman gave recognition to this latter problem when, in concluding his extensive statement on government credit policies issued February 26, he referred to steps being taken to restrict government lending. He stated that he was directing government credit agencies to report to him on the nature and extent of their lending "so that these operations may again be reviewed as part of our over-all anti-inflationary program".

It is hoped that this inquiry will be vigorously pursued and every effort made to bring government lending operations in line with the principles that have been laid down for private lenders. By joint cooperative efforts of government and the people it should be well within the power of the American democracy to devote 15 to 20 per cent of its productive capacity at these high levels to defense without allowing inflation and disorganization of the economy, or stultifying regimentation of our lives.

Lessons Learned Too Well?

Major lettuce growers of California's Salinas Valley, known as the "salad bowl of the nation," have been charged in a Federal District Court with violating the anti-trust laws by destroying lettuce crops to raise prices and limit quantities available to consumers.

So runs a despatch to the New York Times of May 19.

Complainant in the case is the Attorney General of the United States, Mr. J. Howard McGrath. Object — an injunction restraining growers from plowing under their crops.

Action, it seems, is based on an alleged agreement to destroy lettuce planted by April 1 and to be harvested before June 2 "in such quantities and at such times as may be agreed upon by a committee of the defendant growers" to keep up the price levels. The story continues —

> Sidney Church, attorney for the growers' committee, said that "last year the industry plowed under thousands and thousands of acres of lettuce," and he added: "Growers took big losses. This year we are plowing under the same amount but with a plan, so that we can spread out the losses."
>
> Mr. Church said more lettuce was destroyed last year than this, after it was found unprofitable to try to market it.

All very reprehensible of course. But the lettuce growers have had some pretty good examples of how to "raise prices" and "limit quantities available to consumers", not only by plowing under crops but by slaughtering little pigs and buying up foodstuffs that were left in warehouses to spoil or dumped out in the fields to rot. The Attorney General of the United States, who is seeking to enjoin these lettuce growers from their nefarious practices, may be pardoned a blush if he stops to think who started all this in the first place.